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December 13, 1994

Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, NW, Room 222  
Washington, D. C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

Re: Ex Parte Presentation  
CC Docket No. 94-1  
Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

On Tuesday, December 13, 1994, Mr. Paul Malandrakis and I met with Mr. A. Richard Metzger and Ms. Anna Gomez of the Common Carrier Bureau to discuss AT&T's previous stated position in the above mentioned docket. The attachment was used as the basis of our discussion.

In accordance with Section 1.1206(a)(1) of the Commission's Rules, two (2) copies of this Notice are being submitted to the Secretary of the FCC on the date of the meeting.

Sincerely,

A handwritten signature in cursive script that reads "Bruce K. Cox".

Attachment

cc: Mr. A. Richard Metzger  
Ms. Anna Gomez

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***AT&T Position on Issues Related to:***

**PRICE CAP PERFORMANCE REVIEW FOR  
LOCAL EXCHANGE CARRIERS**

***(CC Docket No. 94-1)***

- 1. PRODUCTIVITY**
- 2. COST OF CAPITAL**
- 3. SHARING**
- 4. PRICING FLEXIBILITY**
- 5. EXOGENOUS COSTS**
- 6. COMPETITIVENESS OF LOCAL EXCHANGE  
MARKETS**
- 7. REGULATORY CHANGES TO ACCOMMODATE  
LOCAL EXCHANGE COMPETITION**

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**FEDERAL COMMUNICATIONS COMMISSION  
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## **PRODUCTIVITY**

**THE LECs HAVE ACHIEVED PRODUCTIVITY LEVELS IN THE MID FIVE PERCENT RANGE UNDER PRICE CAP REGULATION: 1991-94 (as measured using the FCC's actual price cap formulas)**

- 1. AT&T Direct Model:  $X = 5.4\%$  to  $5.6\%$** 
  - Understates actual  $X$  because of net demand repression resulting from excessive LEC pricing
  - Model has not been controverted by USTA
  - PacTel's attempted refutation is erroneous because of their improper tax gross-up calculation
- 2. FCC/AT&T/GSA Simple Model:  $X = 5.3\%$  to  $5.5\%$** 
  - Understates actual  $X$  because effect on ROR from undercap pricing is not incorporated
  - Corrected per USTA/NERA
- 3. Ramifications of the LECs achieving mid 5% productivity while only being required to price to 3.3%/4.3% productivity**
  - LEC RORs have grown by over .8% per year

	1/1/91	1991	1992	1993	1994
RBOC	11.25%	11.79%	12.60%	13.39%	~14.5%
Tier 1	11.25%	11.65%	12.39%	12.85%	~14%
  - If  $X$  is not raised to the mid 5%s, this ROR inflation will continue indefinitely

## **ACHIEVING 5 + % LEVELS OF PRODUCTIVITY GROWTH IS NOTHING NEW FOR THE LECs**

- 1. The FCC's Frentrup-Uretsky study showed 5 + % productivity growth for 1985-90**
- 2. Christensen's TFP study for 1984-92 – adjusted for the contemporaneous differential in input price growth (shown by Ad Hoc and AT&T) – implies a LEC total company productivity of 5.2%**
- 3. The *only* study disagreeing with 5 + % productivity growth for the LECs is USTA's effort to "update" the Frentrup-Uretsky study**
  - The results of this study are incredible
    - Total X below CL and TS Xs
    - Implied 1991-92 productivity of about 0.22%
  - Demonstrated faults in this study explain quite well why it arrives at such severely understated value for X
    - Incorrect weighting of CL and TS X
    - Use of erroneous 1984 data
    - Use of data that differ from original Frentrup-Uretsky data
    - Data not restricted to price cap LECs
    - Neglect of 1993-94 data
    - Excessive and illogical implementation of demand stimulation adjustments

**THE PRICE CAP LEC X SHOULD BE SET AT 5.5%  
ON A GOING FORWARD BASIS**

- 1. This level (without a CPD additive) matches the level that the LECs achieved under price cap regulation (1991-94)**
- 2. This level matches the level that the LECs achieved under ROR regulation (1985-90) prior to entering price caps – plus a .5% CPD**
- 3. This level does not “recapture” *any* of the \$2.4B in excess revenues that the LECs have accumulated so far during the first three and one half years of price caps**

## **COST OF CAPITAL**

**OVER THE LAST FOUR YEARS, PRICE CAP LECs HAVE EARNED A ROR THAT HAS NOW CLIMBED INTO THE 14% RANGE**

- 1. Growth in LEC ROR has been close to .8% per year**
- 2. This growth has resulted in rates that are now \$1.3B more *per year* than rates that reflect an 11.25% ROR**
- 3. Cumulatively over four years (1991-94), LEC rates will exceed rates reflecting an 11.25% ROR by close to \$2.9B.**

**OVER THE LAST FOUR YEARS, THE LECs' COST OF CAPITAL HAS AVERAGED ABOUT 10%**

- 1. This represents a 1.25% drop from their price cap initialized level of 11.25%**
- 2. This drop has caused LEC rates to be further inflated over the price cap initialized level by more than \$600M annually**

**THIS DISPARITY SHOULD BE CORRECTED BY AN UP-FRONT RATE CUT OF \$322M PER YEAR AND BY A 1.25% REDUCTION IN THE SHARING ZONE THRESHOLDS**

- 1. \$322M represents the amount by which the LECs have benefited from the reduction in their cost of capital beyond what has been reflected in GNP-PI**
- 2. If this rate cut is implemented, the going forward LEC X could be reduced by .4% from its otherwise appropriate value of 5.5%**

**UNLESS THESE RATE ADJUSTMENTS ARE ORDERED, THE LECs' ROR WILL BECOME ENTRENCHED AT ITS CURRENT 14% LEVEL – EVEN IF THE LEC X IS RAISED TO THE MID 5% LEVEL**

## **SHARING**

### **UPPER SHARING SHOULD NOT BE ELIMINATED**

- 1. Upper sharing provides necessary assurance that rates for monopoly service elements remain just and reasonable**
- 2. The associated ARMIS and 492 reporting data that are associated with fulfilling sharing requirements are indispensable for monitoring the performance of LEC price cap regulation**

### **ALL PARTIES ARE AGREED THAT LOWER SHARING SHOULD BE ELIMINATED**

- 1. Removal of lower sharing will prevent LECs from making up lower earnings on more competitive services through rate increases on monopoly services**
- 2. Video Dial Tone is a good current example**



## **PRICING FLEXIBILITY**

**LECs SHOULD BE REQUIRED TO ASSIGN SERVICES TO BASKETS AND BANDS ON A BASIS THAT IS CONSISTENT NATIONALLY ACROSS ALL LECs**

**ZONE DENSITY PRICING DIFFERENTIALS SHOULD BE JUSTIFIED ON THE BASIS OF COST**

**AN ACROSS-BASKET "LOW DENSITY INDEX" SHOULD BE ESTABLISHED**

- 1. Such an index will help assure the reasonableness of access rates for residential and rural customers**
- 2. The Index should have an overall + 1% upward annual ceiling**

## **EXOGENOUS COSTS**

### **THE APPROPRIATENESS OF EXOGENOUS COST TREATMENT SHOULD BE EVALUATED ON A CASE-BY-CASE BASIS**

- 1. There is no simple, *a priori* rule that can distinguish between appropriate and inappropriate exogenous costs**
- 2. The expiration of Equal Access Network Recovery (EANR) amortizations and cost reductions resulting from the sale of high cost exchanges should be given exogenous treatment**

## **COMPETITIVENESS OF LOCAL EXCHANGE MARKETS**

**THERE IS NO EVIDENCE THAT LOCAL EXCHANGE  
MARKETS CURRENTLY FACE WIDESPREAD AND  
EFFECTIVE COMPETITION**

- 1. To the extent any competition exists today, it is in  
niches and may only be the result of LEC monopoly-  
level pricing**
- 2. Without the substantial legal, regulatory and technical  
reforms outlined in AT&T's Nine Points, effective  
local exchange competition may never develop**

**THE USTA-PROPOSED "ADDRESSABILITY" TEST  
WOULD ALLOW SERVICES TO BE CLASSIFIED AS  
COMPETITIVE EVEN THOUGH THE LEC STILL  
MAINTAINS MONOPOLY CONTROL**

## **REGULATORY CHANGES TO ACCOMMODATE LOCAL EXCHANGE COMPETITION**

**UNTIL WE SEE HOW COMPETITION ACTUALLY  
DEVELOPS, IT IS PREMATURE TO DEVISE  
MECHANISMS TO ACCOMMODATE THAT  
COMPETITION**

**THE USTA-PROPOSED DEREGULATION  
MECHANISM WOULD ALLOW LECs TO EXPLOIT  
CAPTIVE CUSTOMERS**